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IN THE

Supreme Court of the United States

October Term, 1966

No. 343

PRIMA PAINT CORPORATION,
Petitioner,

against

FLOOD & CONKLIN MFG. CO.,
Respondent.

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Citations to Opinions Below

The opinion of the United States District Court for the Southern District of New York (Croake, D.J.) is unreported and is printed herein (R. 8). The opinion in the Court of Appeals, reported in 360 F.2d 315, is printed herein (R. 45).

Jurisdiction

The jurisdiction of this court is invoked under 28 U. S. C. §1254(1). The judgment of the Court of Appeals was entered on May 12, 1966. Certiorari was granted October 17, 1966, — U. S. —, 87 S. Ct. 202, 17 L. Ed. 2d 130.

Questions Presented

1. Whether a contract wherein and whereby one of the parties is employed to serve in an advisory and consultative capacity constitutes a contract evidencing a transaction involving interstate commerce.

2. Where jurisdiction exists solely by virtue of diversity of citizenship, the Federal Arbitration Act requires the validity of an arbitration agreement contained in a contract evidencing a transaction in interstate commerce to be determined in accordance with applicable state created rights.

3. Construing the Arbitration Act as creating federal substantive law, an arbitration clause in a contract does not exist as a separable, special agreement.

4. Construing the Arbitration Act as creating federal substantive law, an arbitration clause covering "any controversy or claim arising out of or relating to this agreement, or the breach thereof", requires the question of whether the contract containing such arbitration clause has been fraudulently induced, to be in the first instance determined judicially.

Statutes Involved

The statutory provisions involved are §§2, 3 and 4 of the Federal Arbitration Act of 1925, now 61 Stat. 669 (1947), 68 Stat. 1233 (1954), 9 U.S.C. §§2, 3 and 4 and §7503(c) of the New York Civil Practice Law and Rules.

Federal Arbitration Act

§2. Validity, irrevocability, and enforcement of agreements to arbitrate.

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

§3. Stay of proceedings where issue therein referable to arbitration.

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

§4. Failure to arbitrate under agreement; petition to United States Court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement

for arbitration may petition any court of the United States which, save for such agreement, would have jurisdiction under the judicial code at law, in equity, or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by law for the service of summons in the jurisdiction in which the proceeding is brought. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by law for referring to a jury issues in an equity action, or may

specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

New York Civil Practice Law and Rules

§7503. Application to compel or stay arbitration; stay of action; notice of intention to arbitrate.

(c) Notice of intention to arbitrate. A party may serve upon another party a notice of intention to arbitrate, specifying the agreement pursuant to which arbitration is sought and the name and address of the party serving the notice, or of an officer or agent thereof if such party is an association or corporation, and stating that unless the party served applies to stay the arbitration within ten days after such service he shall thereafter be precluded from objecting that a valid agreement was not made or has not been complied with and from asserting in court the bar of a limitation of time. Such notice shall be served in the same manner as a summons or by registered or certified mail, return receipt requested. An application to stay arbitration must be made by the party served within ten days after service upon him of the notice or he shall be so precluded. Notice of such application shall be served in the same manner as a summons or by registered or certified mail, return receipt requested.

Statement of the Case

Petitioner, Prima Paint Corporation, a Maryland corporation (hereinafter referred to as "Prima"), instituted an action in the United States District Court for the Southern District of New York on November 12, 1965 seeking to rescind a contract of employment dated October 7, 1964, containing an arbitration clause, alleging that the defendant-respondent, Flood & Conklin Mfg. Co. (hereinafter referred to as "F & C"), a New Jersey corporation, had falsely and fraudulently induced Prima, the plaintiff, to accelerate the closing date thereof and execute same (R. 18-21).

F & C agreed to serve Prima "in an advisory and consultative capacity", for a six year period ending October 7, 1970 to the extent Prima might reasonably require. The specified employment, obviously managerial in nature was to be rendered by a particular individual; further F & C agreed not to compete with Prima and to turn over certain customer lists. Prima agreed to make payments to F & C, based upon its sales to said customers, commencing Sept. 1, 1965. The agreement contained provisions defining defaults to consist of Prima's insolvency, an attachment or levy upon the customer accounts, etc., or failure to pay, and upon the occurrence of any one condition, the customer accounts would "automatically revert at once to F & C" without any requirement on the part of F & C to repay or return any portion of payments received from Prima (R. 21-27). The said agreement contained an arbitration clause as follows:

> "8. *Arbitration.* Any controversy or claim arising out of or relating to this Agreement, or the breach

thereof, shall be settled by arbitration in the City of New York, in accordance with the rules then obtaining of the American Arbitration Association, by three arbitrators, one of whom shall be an attorney-at-law and one of whom shall be a certified public accountant, and judgment upon the award rendered may be entered in any Court having jurisdiction thereof. The costs of arbitration shall be shared equally by Prima & F&C."

The jurisdiction of the court below was founded solely on diversity of citizenship and amount (R. 18).

Petitioner alleged that respondent, knowingly, falsely and fraudulently represented that it was a solvent corporation whereas, seven days after execution of the said agreement, and on October 14, 1964, respondent, F & C, filed a voluntary petition under Chapter XI of the Bankruptcy Act and a Receiver of its property was appointed. Upon confirmation of its arrangement proceedings, by order dated March 16, 1965, respondent was revested with title to its property and the instant litigation ensued.

Prima made the first payment as required by the agreement to an escrowee under protest. In its letter of transmittal dated September 17, 1965, Prima alleged various "breaches" of the agreement by F & C, primarily asserting fraud in inducing the said agreement (R. 28-30).

Thereafter, on October 25, 1965, F & C served a Notice of Intention to Arbitrate on Prima pursuant to Section 7503 (c) of the Civil Practice Law and Rules of the State of New York (R. 31-32). The substantive effect thereof, under New York law, would have been to preclude Prima

from objecting that a valid agreement was not made unless Prima applied to a court to stay arbitration.

On November 12, 1965, Prima timely instituted a federal action *solely* seeking to rescind the agreement on the grounds of fraud in the inducement and contemporaneously sought to stay arbitration pending a disposition of its rescission action (R. 11-13). Prima alleged that F & C had represented that it was in all respects a solvent corporation, able to perform the terms and conditions of the agreement, whereas during the time of the negotiations, and even on the threshold of its execution, F & C knew or had reasonable cause to know that it was insolvent and in fact was preparing to immediately file a petition in bankruptcy. That, as a result, Prima was deprived of F & C's services, and suffered substantial diminution in value of F & C trade names, labels, customer accounts, and goodwill conveyed to Prima (R. 40-41).

F & C simultaneously cross-moved pursuant to the provisions of the Federal Arbitration Act, 9 U.S.C. §1 *et seq.* to stay the federal rescission action instituted by Prima and compel arbitration (R. 8-11).

Relying on the precedent of *Robert Lawrence, infra,* the District Court, disposing of both motions, ruled (1) that no fraud is specifically alleged with regard to the arbitration provision; (2) that the said clause is sufficiently broad to cover a dispute over fraudulent inducement, and accordingly, denied Prima's motion to stay arbitration, granted F & C's motion to stay the rescission action, and directed the parties to proceed with arbitration (R. 8-11).

An appeal was timely taken to the Court of Appeals (R. 5) but prior to the time within which the record, briefs and appendices were to be filed, the respondent moved to dismiss the appeal as frivolous (R. 1). Upon oral argument of the motion, the court, at its own request and with the consent of counsel, agreed to hear and determine the appeal on its merits, resulting in an opinion and order dismissing the appeal (R. 45-50).

The Court of Appeals, going further than the District Court, found that the action is a diversity action; that the contract evidences a transaction involving interstate commerce; that the arbitration agreement is separable from the contract within which it is contained and where there is no allegation of fraud in the inducement to enter into the agreement to arbitrate, the issue of fraud as to any other portion of the agreement is properly the province of the arbitrators and not the court.

POINT I

Whether a contract wherein and whereby one of the parties is employed to serve in an advisory and consultative capacity constitutes a contract evidencing a transaction involving interstate commerce.

An Act of Congress is not to be interpreted as superseding all state law dealing with some phase of interstate commerce unless such intent is manifest by the language of the act and the scope which Congress meant it to have for the accomplishment of its apparent aim. *Cloverleaf Butter Co.* v. *Patterson,* 315 U.S. 148, 62 S.Ct. 491, 86

L.Ed. 754 (1942); *Cities Service Gas Co.* v. *Peerless Oil & Gas Co.*, 340 U.S. 179, 71 S.Ct. 215, 95 L.Ed. 190 (1950). Moreover, resort by the courts to the commerce clause cannot defy standards of due process. *Sec'y of Agriculture* v. *Central Roig Ref. Co.*, 338 U.S. 604, 70 S.Ct. 403, 94 L.Ed. 381 (1950).

The purpose of the commerce clause is to protect commercial intercourse from invidious restraint, to prevent interference through conflicting or hostile state laws, and to insure uniformity in regulation (11 Am. Jur., Commerce, §2). However, it is no longer open to question that the formation of a contract between persons in different states is not within the protection of the commerce clause unless the *performance* thereof is within its protection. *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 58 S.Ct. 546, 82 L.Ed. 823 (1938).

The agreement herein employed F & C to work for Prima for a six year period. If the agreement had been carried into effect, Jerome K. Jelin, Chairman of F & C, would have been required to perform the services of employment on behalf of F & C. Only his out-of-pocket expenses would have been reimbursed by Prima.

These facts do not make this a contract evidencing a transaction in interstate commerce. *San Carlo Opera Co.* v. *Conley*, 72 F.Supp. 825 (S.D.N.Y. 1946), *aff'd*, 163 F.2d 310 (2d Cir. 1947). Any travel in connection with the agreement is a mere incident, not the essential thing. That to which it is incident—the advice and consultation—would not be called trade or commerce in the commonly accepted use of these words. Personal effort, not related to production,

is not a subject of commerce. That which is in its consummation, not commerce, does not become commerce among the states because transportation takes place. *Federal Baseball Club* v. *National League,* 259 U.S. 200 (1922); *Hart* v. *B. F. Keith Vaudeville Exchange,* 12 F.2d 341 (2d Cir. 1926), *cert. denied,* 273 U.S. 704 (1926).

In the *Bernhardt* case, *infra,* the employee was a plant superintendent earning $15,000.00 a year with managerial duties fundamentally those different from workers. It is apparent from this agreement that F & C, through Jerome K. Jelin, would be rendering what would amount to personal and managerial duties which would be fundamentally different than those of workers.

The significant question, therefore, is not whether, in carrying out the terms of the contract, the parties *did* cross state lines, but whether, at the time they entered into it and accepted the arbitration clause, they contemplated substantial interstate activity. Cogent evidence regarding their state of mind at the time would be the terms of the contract and if it, on its face, evidences interstate traffic, such as did the shipment from New York to Massachusetts in the *Lawrence* case, cited *infra,* the contract would come within Section 2. In addition, evidence how the parties expected the contract to be performed and how it was performed is relevant to whether substantial interstate activity was contemplated. *Metro Industrial Painting Corp.* v. *Terminal Construction Corp.,* 287 F.2d 382, 387 (2d Cir. 1961), *cert. denied,* 368 U.S. 817, 82 S.Ct. 31 (1961).

> "the fact that it is necessary for one party to cross state lines in order to fulfill obligations arising out of the contract should not by itself bring the arbi-

> tration clause within the reach of the Federal Statute . . ." (*Metro Industrial Painting Corp.* v. *Terminal Const. Corp., supra,* p. 388.)

Like the *San Carlo Opera* case, *supra,* the agreement involved herein was one for personal employment and specified the particular person who would render said employment.

This contract does not evidence a transaction in interstate commerce but is merely an agreement for personal or managerial services; as such, the Federal Arbitration Act is inapplicable and the court below erred in not applying state law to determine the issues raised and the rights of the litigants.

POINT II

Where jurisdiction exists solely by virtue of diversity of citizenship, the Federal Arbitration Act requires the validity of an arbitration agreement contained in a contract evidencing a transaction in interstate commerce to be determined in accordance with applicable state created rights.

The Court of Appeals for the Second Circuit reaffirmed the unique precedent originally established by it in the case of *Robert Lawrence Co.* v. *Devonshire Fabrics, Inc.,* 271 F.2d 402 (2d Cir. 1959), *cert. granted,* 362 U.S. 909 (1960), *dismissed pursuant to Rule 60,* 364 U.S. 801 (1960), holding that:

> "The Arbitration Act in making agreements to arbitrate 'valid, irrevocable, and enforceable' *created national substantive law clearly* constitutional under the maritime and commerce powers of the Congress

> and that the rights thus created are to be adjudicated by the Federal Courts whenever such courts have subject matter jurisdiction, *including diversity cases . . .*"[1]

The court concluded that this "national substantive law" (if there be such) requires, even where jurisdiction is based solely on diversity of the parties, that an arbitration agreement be separable from the contract within which it is contained, and notwithstanding contrary state law, where there is no allegation of fraud in the inducement to enter into the agreement to arbitrate, the resolution of whether there was in fact fraud in the inducement of the contract containing the arbitration agreement is properly within the province of the arbitrators and not the court.

This result is in direct conflict with the holdings of the 9th Circuit in *Ross* v. *Twentieth Century-Fox Film Corp.*, 236 F.2d 632 (1956); the 6th Circuit in *American Airlines, Inc.* v. *Louisville & Jefferson County Air Board,* 269 F.2d 811 (1959), and, further contradicts the stated position of the 1st Circuit, indicated by *dicta* in *Lummus Co.* v. *Commonwealth Oil Refining Co.,* 280 F.2d 915 (1960), *rehearing denied,* 280 F.2d 932 (1960), *cert. denied,* 364 U.S. 911 (1960). In effect, the 2d Circuit directly overruled its own earlier decision in *Kulukundis Shipping Co.* v. *Amtorg Trading Corp.,* 126 F.2d 978 (2d Cir. 1942).

In order to establish this unique precedent, the Second Circuit admittedly disagreed with an eminent Associate Justice of this court[2]; and then, without any basis in fact

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[1] 271 F. 2d 402, 409; R.50 (Additional emphasis supplied).

[2] *Robert Lawrence* v. *Devonshire Fabrics, Inc.,* 271 F. 2d 402, 404.

or in law, misconstrued Congressional intent and created a legal fiction of separability of the arbitration clause from the contract within which it is contained, in order to avoid accepted constitutional limitations enunciated by this court in *Erie R. Co.* v. *Tompkins,* 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188, 114 A.L.R. 1487 (1938); *Guaranty Trust Co.* v. *York,* 326 U.S. 99, 65 S.Ct. 1464, 89 L.Ed. 2079, 160 A.L.R. 1231 (1945); and *Bernhardt* v. *Polygraphic Co. of America, Inc.,* 350 U.S. 198, 76 S.Ct. 273, 100 L.Ed. 199 (1956).

A. The United States Arbitration Act does no more, nor was it intended by Congress to do more, than regulate the manner in which federal courts are to enforce state created rights in diversity cases.

This court, in *Bernhardt* v. *Polygraphic Co. of America, Inc., supra,* reversed an attempted interpretation by 2d Circuit of §3 of the Arbitration Act, which had construed the same to liberally apply and affect *all contracts,* regardless of subject matter, holding that "§§1, 2, and 3 are integral parts of a whole . . . §§1 and 2 define the field in which Congress was legislating."[3]

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[3] Compare, *U. S.* v. *Electronic & Missile Facilities, Inc.,* 364 F. 2d 705, (2d Cir. 1966) where the 2d Circuit recently stayed the suit of a subcontractor commenced under The Miller Act on the ground that the subcontract provided for arbitration of all disputes; holding that the Arbitration Act is broad enough to include Miller Act suits within its scope and distinguishing *Wilko* v. *Swan,* 346 U. S. 427, 74 S.Ct. 182, (1953) and *Bernhardt* v. *Polygraphic Co. of America, Inc., supra.* Although the jurisdiction was invoked on grounds other than diversity of the parties, the court, nevertheless, construed § 3 as applying, specifically disregarding whether the contract was within § 2. *The court then applied state substantive law to determine validity of the arbitration clause.*

Having found that §2 is definitional in scope in *Bernhardt, supra,* the constitutional question avoided therein, but presented in the instant case, compels the conclusion, in the light of *Erie* and *York,* that the Arbitration Act merely regulates the manner in which federal courts are to enforce state created rights in diversity cases.

In *Shanferoke Coal & Supply Corp.* v. *Westchester Service Corp.,* 293 U.S. 449, 55 S.Ct. 313, 79 L.Ed. 583 (1935), a pre-*Erie* case, the Arbitration Act was applied in a diversity case, involving interstate commerce, however, the majority in *Bernhardt* v. *Polygraphic Co., supra,* pointedly indicated that *Shanferoke's* application to a diversity case might be decided differently today. By thus inferentially overruling *Shanferoke,* this court demonstrated its intention to apply the *Bernhardt* doctrine equally to all diversity cases, inclusive of contracts involving interstate commerce.

The majority opinion intimates, and Mr. Justice Frankfurter's concurrence explicitly states:

> "Since the United States Arbitration Act of 1925 does not apply to diversity cases, in the light of its terms and relevant interpretive materials, avoidance of the constitutional question is for me sufficiently compelling to lead to a construction of the Act as not applicable to diversity cases."[4]

B. The Act's language, scope and background conclusively support a construction that §2 is purely remedial in character when applied to a diversity situation.

Except for §§1 and 2, all the other sections of the Act deal solely with enforcement. Is it manifestly clear from

[4] 350 U. S. 198, 208 (1956).

its legislative history (Cong. Rec. pg. 1931, 68 Cong. 1st Sess. (1924); H.R. Rep. No. 96, 68 Cong., 1st Sess. (1924); S. Rep. No. 536, 68 Cong. 1st Sess. (1924)), that Congress in enacting this statute sought and intended to provide the federal courts solely with procedural machinery or a regulatory scheme with which to enforce arbitration agreements.[5] It intended to grant "no new rights, except a remedy to enforce an agreement." (Cong. Rec. pg. 1931, 68 Cong. 1st Sess. (1924).

The statute was enacted into law by Congress on February 12, 1925, a year after this court's decision in *Red Cross Line* v. *Atlantic Fruit Co.*, 264 U.S. 109, 44 S.Ct. 274, 68 L.Ed. 582 (1924), declaring such an agreement valid. Therefore, Congress was not creating rights where none had heretofore existed, *but was merely affording a procedure for the enforcement of then existing rights.*

The Senate Committee referred[6] to *Red Cross Line* v. *Atlantic Fruit Co., supra,* in which arbitration was characterized as relating to remedy. Despite criticism of the case for its characterization of arbitration,[7] Congress' reliance on it demonstrates its intention and understanding that the

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[5] The Report of the House Committee stated in part: "Arbitration agreements are purely matters of contract, and the effect of the Bill is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him. An arbitration agreement is placed upon the same footing as other contracts, where it belongs . . . The Bill declares simply that such agreements for arbitration shall be enforced, and provides a procedure in the Federal courts for their enforcement."

[6] S.Rep. No. 536, 68 Cong., 1st Sess. 3 (1924).

[7] Kochery, The Enforcement of Arbitration Agreements in the Federal courts: *Erie* v. *Tompkins,* 39 Cornell L. Q. 74, 83 (1953).

Arbitration Act was to regulate procedure in the federal courts.

Moreover, it is significant that the Arbitration Act was patterned upon the New York statute (N. Y. Sess. Laws 1920, ch. 275 (now N.Y.C.P.L.R., §7501 *et seq.*) which had been passed five years earlier and held constitutional by New York's highest court (*Berkowitz* v. *Arbib & Houlberg, Inc.*, 230 N.Y. 261, 130 N.E. 288 (1921), on the ground that arbitration is part of the law of remedies. See *Meacham* v. *Jamestown F. & L. R.R.*, 211 N.Y. 346, 105 N.E. 653 (1914).

The only proper construction to be accorded §2 by this court, where jurisdiction is founded upon diversity of citizenship, was suggested by Mr. Justice Frankfurter in his *Bernhardt* concurrence; that the Arbitration Act, and the institution of proceedings under it, cannot create rights, but can only provide a *means* for adjudicating the parties' underlying dispute founded upon state created rights.[8]

That Congress intended §2 to be remedial in its scope is evident from the complete absence of any expressed Congressional intent to make the Arbitration Act applicable to state court actions, and the view of contemporary writers that such effect was not intended.[9]

Further support for this proposition is found in the *Robert Lawrence* case itself, where in *dicta*, Judge Medina noted that:

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[8] 350 U.S. 198, 207-9 (1956).

[9] Cohen & Dayton, The New Federal Arbitration Law, 12 Va. L.Rev. 266,277 (1926); 20 Ill. L.Rev. 111 (1925); 11 A.B.A.J. 153,155 (1925).

"... suits involving the application of the Arbitration Act do not furnish an independent basis of federal jurisdiction under 28 U. S. C. §1331."[10]

If §2 is construed as conferring federal rights only when the *fortuity* of diversity of citizenship or other grounds of jurisdiction exist, but not otherwise, it would then raise serious collateral constitutional questions concerning denial of equal protection of the law and due process of law, and would further result in binding the state courts in a manner obviously not intended by Congress when it enacted the Arbitration Act. Such an interpretation would conflict with constitutional limitations and precedent established by the *Erie* and *York* cases; only serve to resurrect the spectre of *Swift* v. *Tyson*, 41 U.S. (16 Pet.) 1, 10 L.Ed. 865 (1842), making the rights of litigants vary according to whether enforcement was sought in the state or in the federal courts; encourage forum shopping,[11] and subject parties to prelitigative uncertainty of obligation.

POINT III

Construing the Arbitration Act as creating federal substantive law, an arbitration clause in a contract does not exist as a separable, special agreement.

A. Doctrine of Separability

This court has recognized that ordinary commercial arbitration agreements are founded on axiomatic contract prin-

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[10] 271 F.2d 402, 408 (1959).

[11] 24 N.Y. County Lawyers Assoc. Bar Bul. 17, (1967), wherein the resulting difference in outcome based on selection of the courthouse was emphasized.

ciples and function differently from disputes involving a national interest protected by intended Congressional enactment. *Atkinson* v. *Sinclair Refining Co.*, 370 U.S. 243, 82 S.Ct. 1318 (1962). Grievances arising from commercial contracts made between private citizens are not steeped in strong national interest or policy, such as instances where industrial strife occurs, as represented by the National Labor Act cases [12] requiring federal courts to make common law under the provisions of §301 of the Taft Hartley Act (61 Stat. 156 (1947); 29 U.S.C. §185 (1958).

Even in these instances, this court has always recognized that the making of such an agreement is a justiciable question;

> "To be sure, since arbitration is a creature of contract, a court must always inquire, when a party seeks to invoke its aid to force a reluctant party to the arbitration table, whether the parties have agreed to arbitrate the particular dispute. In this case, the question of whether a dispute is 'arbitrable' is inescapably for the court." (Separate opinion of Brennan, J.; Harlan, J., concurring *United Steelworkers of America* v. *American Manufacturing Co., etc.*, 363 U. S. 570).

In the area covered by the Arbitration Act, less of a problem is given to the judiciary, than that of appreciating institutional difficulties and fashioning a body of law such

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[12] *Textile Workers* v. *Lincoln Mills*, 353 U.S. 448, 77 S.Ct. 912, 1 L.Ed.2d 973 (1957); *United Steelworkers* v. *American Manufacturing Co.*, 363 U.S. 564, 80 S.Ct. 1343, 4 L.Ed.2d 1403 (1960); *United Steelworkers* v. *Warrior & Gulf Nav. Co.*, 363 U.S. 574, 578, 80 S.Ct. 1347; 4 L.Ed.2d 1409 (1960).

as occurs in the labor-management field, since the issues presented for judicial consideration in ordinary commercial agreements will be narrower, and there will be no need to consider the complexities peculiar to collective-bargaining agreements.

In *Moseley* v. *Electronic & Missile Facilities, Inc.*, 347 U.S. 167, 172, 83 S.Ct. 1815, 10 L.Ed.2d 818 (1963), the Chief Justice and Mr. Justice Black, concurring, established their position on the precise issue herein presented, in stating:

> "We agree with the court that fraud in the procurement of an arbitration contract, *like fraud in the procurement of any contract, makes it void and unenforceable and that this question of fraud is a judicial one,* which must be determined by the court. To allow this question to be decided by arbitrators would be to that extent to enforce the arbitration agreement, even though steeped in the grossest kind of fraud". (Emphasis supplied.)

It has been recently suggested by this court, *Drake Bakeries, Inc.* v. *Local 50, American Bakery,* 370 U.S. 255, 261, 80 S.Ct. 1346 (1962), that arbitration clauses and no-strike clauses do not justify either party to the contract in wrenching them from their context, on the ground that they are mutually dependent covenants *which are separate from the other promises between the parties,* and that the issue of arbitrability is a question for the courts and is to be determined by the contract entered into by the parties.[13] The court noted, unlike the case at bar, that the petitioner

[13] 370 U.S. 261, n.7.

had not attempted or claimed the right, either to *terminate the entire contract* or extinguish permanently its obligations thereunder.

B. Proper Law to Apply

Assuming the intention of Congress in §2 was to furnish the right to have agreements to settle disputes by arbitration treated no differently from other contracts, the said right would be properly protected by applying state law to decide a dispute over the making or the validity of the contract.

The Congressional purpose was the more limited one of removing outmoded judicial hostility to the specific enforcement of an arbitration agreement before an award. The use of the word "valid" should be regarded as merely restating the pre-existing law that an arbitration award was judicially enforceable, and that even if an arbitration agreement was not specifically enforceable, nominal damages could be recovered for its breach.[14]

Such a construction is justifiable because Congress did not displace the underlying state-created rights on the contract. Thus, the question whether an arbitration clause is separable, and whether any contract exists, refers to the same body of law under which all other rights except enforceability of the arbitration clause are determined. The considerations favoring the application of state law apply with particular force with respect to the question of the interpretation of an arbitration clause, since the statute

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[14] H.R.Rep. No. 96, *supra;* S.Rep. No. 536 *supra;* 66 Cong.Rec. 984 (1925).

makes no mention of interpretation. Furthermore, New York courts do not appear to have found any inconsistency between the legislative policy of their state in favor of arbitration, embodied in a statute on which the federal act was based, and the doctrine that the issue raised by a general allegation of fraud in the inducement is not referable to arbitration.[15]

In the final analysis, the contracting parties can easily avoid the danger of hostility toward arbitration manifested in restrictive state-court decisions interpreting an arbitration clause, and obviate same by the use of sufficiently explicit language.

Arbitration would be protected and Congress' intention effectuated without requiring federal judges to fashion, in the absence of any Congressional guidance, a federal common law upon such issues as fraud, duress and mistake, which would result in abrogating and displacing well developed state rules.

The ambiguity and uncertainty of the *separability doctrine* spawned by the 2d Circuit in the *Robert Lawrence* case, *supra*, is amply demonstrated in *El Hoss Engineering* v. *Amer. Ind. Oil*, 289 F.2d 346 (2d Cir. 1961), in which the same court reversed a lower court applying "separability"

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[15] Matter of *Wrap-Vertiser Corp.* (*Plotnick*), 3 N.Y.2d 17, 143 N.E.2d 366; *Manufacturers Chemical Co.* v. *Caswell*, 259 A.D. 321, 19 N.Y.S.2d 171 (1st Dept. 1940), appeal dismissed, 283 N.Y. 679, 28 N.E.2d 404; *Cheney Bros.* v. *Joroco Dresses, Inc.*, 218 A.D. 652, 219 N.Y.S. 96 (1st Dept. 1926), reversed on other grounds, 245 N.Y. 377, 157 N.E. 272; *Reo Garment, Inc.* v. *Jason Corp.*, 9 Misc. 2d 521, 170 N.Y.S.2d 412 (1958); *Greenspan* v. *Greenspan*, 129 N.Y.S.2d 258 (1954); *Exercycle Corp. & Maratta*, 9 N.Y.2d 329, 174 N.E.2d 463 (1961).

as "erroneous". The court concerned itself with first ascertaining the *intent* of the parties from an examination of the entire instrument using the traditional approach of common law judges when questions involving the validity or interpretation of contract are presented.[16] The court held, the intent of the parties was that the arbitration agreement and the enforcement thereof, was conditioned upon the plaintiff's prior performance of certain other terms of the contract, thus resulting in an obstacle to the separability doctrine.

In order to reconcile these holdings, one can only conclude, that the intention of the parties to the contract, applying common law principles is paramount. In the instant case, petitioner contends by its action for rescission, that its intention was fraudulently induced, thereby preliminarily requiring a justiciable determination.

Thus, issues involving the "making" or "validity" of the arbitration agreement, which the Federal Act declares are issues for the Court (see 9 U.S.C. Section 3 and 4), should be decided under state rules of "law and equity". Among such issues would be fraud, duress, mistake and, as held in *American Air Lines Inc.* v. *Louisville & Jefferson County Board, supra,* lack of legal capacity to agree to arbitrate.

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[16] 289 F.2d 346, 349.

POINT IV

Construing the Arbitration Act as creating federal substantive law, an arbitration clause covering "any controversy or claim arising out of or relating to this agreement, or the breach thereof", requires the question of whether the contract containing such arbitration clause has been fraudulently induced, to be in the first instance determined judicially.

A. Equitable rescission for fraud prevents arbitration.

We submit that the Second Circuit erred in its ruling with regard to rescission when it held:

> "... though the recovery sought ... may differ, the ground upon which each recovery is sought, is that of the alleged fraudulent inducement, an issue we hold is one for the arbitrators to resolve" (R. 49).

The Court, when it disregarded the distinction between an action in equity for rescission as opposed to an action at law for damages for fraud, destroyed the petitioner's inherent right to elect its remedy. The ruling ignores the substantive difference between an action at law, which is an affirmance of contract, as contra-distinguished with an action in equity, which is a disaffirmance thereof.

It was well settled at common law that an aggrieved party had a right to relief by way of rescission whenever he had been induced to enter into a contract by either an innocent or fraudulent misrepresentation.[17]

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[17] *Cochran* v. *Cummings*, 4 U.S. 250, 4 Dall. 250, 1 L.Ed. 820 (1802).

> "It is a general rule that a party who has been induced to enter into any contract, obligation, or engagement by means of fraud, deceit, artifice or trickery practiced upon him by the opposite party, and who would not have placed himself in the situation in which he now is, if it had not been for the fraud or deceit, will be entitled to rescind the contract and demand a restoration of the status quo, and have the aid of a court of equity to accomplish this purpose. Fraud is in fact one of the broadest grounds giving jurisdiction to a court of equity, and, when frauds exists, the aggrieved party is not bound to resort to another tribunal, possessed of less power and of less perfect remedies to ascertain the truth and grant relief, although another tribunal, such as a court of law, may also have jurisdiction" (1 *Black on Rescission and Cancellation,* 2d Ed., 24-25).

The doctrine of "clean hands" is essential to equitable relief, therefore the election to rescind is peculiar to the defrauded party.[18] To permit the malfeasor to raise any portion of the document as a barrier to equitable relief would give countenance to the fraud and benefit the perpetrator.[19]

> "It is the peculiar province of equity to relieve against every species of fraud. 'Parties should not be permitted to obtain an unjust advantage over others by trickery . . . 'If a case of fraud be established, a court of equity will set aside all transac-

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[18] 2 Restatement of Contracts §476 (1) (1932).

[19] See also, *Carrington* v. *Pratt,* 59 U.S. 63 (1855); *Scarborough* v. *Atlantic Coast Line R. Co.,* 178 F.2d 253 258 (4th Cir. 1949), *cert. denied,* 339 U.S. 919, 70 S.Ct. 621, 94 L.Ed. 1343 (1950).

> tions founded upon it by whatever machinery they have been effected, and notwithstanding any contrivance by which it may have been attempted to protect them' . . . ". (*Kansas City Southern Ry. Co.* v. *May*, 2 F.2d 680, 687, 8th Cir. 1924).

For the court below to have arbitrarily disregarded the foregoing distinction deprived the petitioner of his substantive rights.

B. An arbitration clause must be dependent.

The determinative test of separability, as enunciated by this court in *United States* v. *Bethlehem Steel Corp.*, 315 U.S. 289, 298, 62 S. Ct. 581, 587 (1942), is:

> ". . . the Courts below, however, treated these clauses as non-separable. To do otherwise would call for departure from accepted principles of the law of contract. Whether a number of promises constitute one contract or more than one is to be determined by inquiring 'whether the parties assented to all the promises as a single whole so that there would have been no bargain whatever if any promise or set of promises were struck out.' *Williston on Contracts*, Rev. Ed. Sec. 863, and cases therein cited."

Assent to arbitration is founded upon the assumption that the underlying transaction is honest, genuine and being candidly consummated. Thus, it is a ridiculous conclusion to believe that men consciously and separably would agree to arbitrate any fraud that would give rise to an action to set aside their agreement.

"A transaction voidable for fraud or misrepresentation cannot be avoided in part . . ."[20]

Applying the traditional approach of common law judges and the precedents of this court, federal substantive law declares that the arbitration clause cannot be severed. It is utterly dependent upon the existence of a subject, and were we to delete this subject leaving only the arbitration clause, there could never have been a bargain, much less a contract evidencing a transaction in interstate commerce. The parties did not consent to arbitration in a vacuum and to say that the parties contemplated fraud is specious.

Furthermore, since arbitration in essence is a waiver of judicial control, due process requires an interpretation that the threshold question of whether the party has in fact agreed to arbitrate and thereby waive judicial rights be justiciably determined.

CONCLUSION

That for the reasons stated, it is respectfully submitted that the judgment of the Court below be reversed.

Dated: New York, N. Y.
January 25, 1967

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[20] 2 Restatement of Contracts, §487 (1932); 6A *Corbin on Contracts*, §1444.